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RUEHSP/AMEMBASSY PORT OF SPAIN 3330
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C O N F I D E N T I A L CARACAS 000183

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ENERGY FOR CDAY, DPUMPHREY, AND ALOCKWOOD
NSC FOR DTOMLINSON

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TAGS: EPET ENRG EINV ECON VE
SUBJECT: BRV BEGINS TO REAP WHAT IT HAS SOWN

REF: A. 2006 CARACAS 03041
¶B. CARACAS 157
¶C. 2006 CARACAS 3224
¶D. CARACAS 38
¶E. CARACAS 83
¶F. 2006 CARACAS 3402

Classified By: Economic Counselor Andrew N. Bowen for Reason 1.4 (D)

¶1. (C) SUMMARY: PDVSA reportedly told tax authorities in August 2006 that it was unable to pay its royalties and taxes due to cash flow problems stemming from social development expenditures. President Chavez' recent statements regarding an increase in gasoline prices appear to stem from PDVSA's cash flow problems. Despite the problems, Venezuela is still shipping gasoline and petroleum to China and Iran at a loss. Service companies have begun to quietly pull equipment out of Venezuela. END SUMMARY

THE CASH COW IS OUT OF MILK

¶2. (C) Petroleum Attache (Petatt) and Economic specialist met with a shipping executive and a marketing executive on January 24 to discuss recent developments in the hydrocarbon sector. The marketing executive stated Seniat, the BRV tax authority, presented PDVSA with a 5 billion USD tax bill. PDVSA officials stated they could not pay the bill because they had a cash flow deficit of 3.5 billion USD. They requested that Seniat give them a tax deduction or credit for the USD 8 billion plus contributions that PDVSA had made to social development funds and projects. Seniat refused to do so and stated PDVSA's tax and royalty payments had already been factored into the BRV budget.

¶3. (C) The marketing executive claimed PDVSA looked into a USD 2.5 to 3.5 billion bond issue last October due to cash flow problems (Reftel A). At the time, analysts thought the BRV was considering the bond issue to soak up excess

liquidity in the Venezuelan economy. He also stated that a number of Energy Minister and PDVSA President Rafael Ramirez' recent comments about PDVSA's profitability and commitment to social development projects also were efforts to stop rumors about the cash flow problem.

¶4. (C) The executives attributed PDVSA's failure to pay joint venture partners and service companies to cash flow problems rather than administrative incompetence or ideology. The marketing executive claimed President Chavez has not signed off on the formation of some of the joint ventures (the former operating service agreement fields) so that PDVSA can use it as an excuse not to pay its joint venture partners. PDVSA simply states it cannot pay its joint venture partners because the joint venture does not legally exist. The executive stated he believes PDVSA owes its joint venture partners 1.2 billion USD. As reported in Reftel B, other contacts place the debt at 2 billion USD. Executives with Baker Hughes (strictly protect) told Petatt on January 25 that PDVSA has been behind in payments to service companies as well as joint venture partners in western Venezuela. The most senior Baker executive stated Chevron and Shell are the only joint venture partners in western Venezuela that have received payment. He was not sure why they received special treatment.

¶5. (C) The shipping and marketing executives claimed President Chavez' recent statements about raising gasoline prices are the direct result of the BRV's realization that its cash cow no longer produces adequate sums of cash. Premium gasoline in Venezuela costs 90 Bolivars per liter (a little over .04 USD). (NOTE: The official exchange rate is

2,150 Bolivars per dollar. END NOTE.) The executives stated the break-even price for the BRV is approximately 200 to 250 Bolivars per liter. However, if the BRV wished to cover its opportunity costs, it would have to raise gasoline prices to 1,250 Bolivars per liter. The executives estimated that this would provide the BRV with an additional 4.8 billion USD. They also stated the BRV would like to couple the price increase with a program to convert 500,000 vehicles to natural gas. According to one plan being floated within the BRV, gas prices would increase to 300 Bolivars per liter and the BRV would use the 50 Bolivars above the break-even point to subsidize public transportation. The executives believe that current local gasoline consumption is approximately 280,000 barrels per day.

MONEY IS NOT AN ISSUE IN POLICYMAKING

¶6. (C) Despite its cash flow problems, PDVSA still makes deals that have little commercial sense. In addition, it appears incapable of fixing operational problems that deprive it of needed revenues. The shipping and marketing executives recently sent a shipment to Iran from the Isla refinery. (COMMENT: We believe the shipment was gasoline. END COMMENT.) PDVSA could not find a tanker and had to use its own tanker, the Negra Primera. The executives said PDVSA lost money on the shipment. PDVSA also sent a 900,000 barrel shipment of Boscan asphalt to China that did not make sense commercially. Due to limitations in Venezuelan port facilities, PDVSA had to send the shipment via small tankers to Curacao and then transfer the shipments to an adequately sized tanker.

¶7. (C) As reported in Reftel C, Venezuela has not been exporting gasoline since July due to refinery problems. Venezuela used to export 80,000 barrels of gasoline per day. The shipping and marketing executives believe Venezuela may be able to make two or three shipments of 24,000 barrels in February, if there are no additional refinery accidents. (COMMENT: No additional refinery accidents strikes us as a very big "if." PDVSA reported on its website on January 24 that three workers were injured in an accident at the Puerto La Cruz refinery. END COMMENT.)

¶8. (C) The BRV's policy of cutting production to meet OPEC

quotas also comes with a significant price tag. The shipping and marketing executives stated Venezuela will have to cut an additional 58,000 barrels per day in February to meet OPEC quotas. The executives stated they believe PDVSA will cut production in Mesa 30. In addition, they believe that PDVSA will cheat on the production cuts by blending 30,000 barrels of Sincor syncrude that was supposed to be cut with Sinovensa's extra heavy crude. As a result, the Sincor syncrude will not leave any fiscal trail and Sincor operations will benefit from efficiencies achieved through economies of scale. (NOTE: Sinovensa's extra heavy crude was used to produce Orimulsion, but the BRV canceled the Orimulsion program (Reftel D). As a result, Sinovensa's extra heavy crude was blended with lighter crudes for marketing purposes. END NOTE.) The executives added that Chinese oil company CNPC has lost the right to market Sinovensa's production. PDVSA is now marketing directly to China and bypassing CNPC.

¶9. (C) PDVSA's OPEC policy also has caused problems for its refinery operations. According to the shipping and marketing executives, the Petrozuata strategic association was close to declaring force majeure as a result of recently announced cuts (Reftel E). The executives said Petrozuata was able to continue making deliveries to the Lake Charles refinery because PDVSA did not send any of its Petrozuata syncrude to the Cardon refinery. The executives said Petrozuata only has a margin of 10,000 barrels if PDVSA does not ship its share of Petrozuata syncrude to Cardon.

COMPANIES BEGIN PULLING EQUIPMENT OUT

¶10. (C) Both the shipping and marketing executives claimed major service companies such as Schlumberger, Halliburton, and Maersk are thinking of pulling equipment out of Venezuela. They also stated smaller drill companies have begun pulling their rigs out of Venezuela. As drilling contracts expire, the smaller companies are quietly pulling their rigs out of Venezuela. The executives claimed that PDVSA called an emergency meeting with the smaller drilling companies and threatened to put them on a "black list" if they pulled out of Venezuela. They also stated some of the smaller drill companies have been offered rig contracts with rates that are 30 percent lower than prevailing market rates. The executives attribute the exodus of rigs to concerns arising out of President Chavez' January 8 "nationalization" speech as well as problems with the CADIVI, the BRV's foreign exchange entity.

¶11. (C) A senior Baker executive told Petatt that he had also heard that smaller drilling companies were leaving Venezuela. He stated he overheard two Pride employees in an airplane gleefully discussing the fact that PDVSA had failed to renew a contract for two small workover rigs. As a result, Pride will pull the rigs out of Venezuela and send them to Colombia. When asked about the emergency meeting with the small drilling companies, the Baker executive said he was unaware of it. However, he stated PDVSA did hold a meeting with drilling companies on January 15 in Caracas and exhorted them to bring more rigs to Venezuela. He stated there was an implied threat if they refused to cooperate. The executive also said he had heard nothing about the delivery of 30 Chinese rigs, which PDVSA supposedly signed a contract for last year.

¶12. (C) The Baker executive said his company has decided to pull pumps out of Venezuela. The executive stated he had to make a presentation recently at his headquarters regarding the present situation in Venezuela. Senior management sent a very clear message that it was going to pursue a very conservative strategy in Venezuela and instructed its Venezuelan managers to focus on increasing before tax profits. The Baker executive listed a number of concerns that his management has in Venezuela. One of the company's biggest problems is that it is working without a contract in a number of projects.

¶13. (C) In addition, Baker has seen a significant decline in its profit margins. PDVSA is not willing to pay increased rates but insists on increased social contributions from service companies. Baker recently received two contracts covering Chevron and Shell's former operating service agreement fields. The language and rates in the two contracts were identical to the old Chevron and Shell contracts. However, the contracts required Baker to make significant social development expenditures. Baker may not deduct its social contributions from gross income for tax purposes nor will it receive any type of credit for the contributions. As a result, its profit margins on the contract will be reduced significantly. The Baker executive stated Venezuela is not as profitable as many other markets.

COMMENT---PDVSA'S ACHILLES HEEL

¶14. (C) Although drilling rigs, mud, and pumps are not as glamorous as multi-billion dollar expropriations, they are vital to the maintenance of Venezuelan oil production. Faced with Chavez' nationalization rhetoric, late payments, no contracts, and declining profit margins, it is not surprising that service companies are trying to limit their exposure to the Venezuelan market. Given PDVSA's cash flow problems, social development obligations, and lack of qualified personnel, it is hard to imagine it filling the void left by departing service companies. Even if PDVSA did have the necessary funds and personnel, it would still be hard-pressed to replace equipment. The Baker executive stated delivery time for the type of pump it is withdrawing from Venezuela is 15 months from the placement of the order. He added that delivery time for certain types of rigs is 100 weeks.

¶15. (C) We believe service companies will try to remove equipment as quickly as possible for two reasons. First, Chavez' comments about nationalizing strategic sectors has created a sword of Damocles situation for the service companies. Petroleum is clearly a strategic sector for the BRV. As a result, service companies feel that they could also be "nationalized". One Baker executive opined that Chavez' January 8 speech completely changed the investment climate in Venezuela. The fact that BRV and PDVSA officials have indicated interest in forcing the service companies into PDVSA-controlled joint ventures does not help matters (Reftel F).

¶16. (C) Second, PDVSA will eventually realize that vital production equipment is flowing out of the country. In fact, one can argue that the meetings with the drilling companies is evidence of a dawning realization of the problem by BRV and PDVSA officials. According to the BakerHughes rig count, there were 66 oil rigs in Venezuela in December 2005. The number increased to 76 in July 2006 but fell to 65 rigs in December 2006. Once the BRV awakens to the gravity of the problem, it is not hard to imagine the BRV taking draconian steps to stop the equipment flow. The companies' predicament brings to mind the old joke about two men who come across a bear in the woods. The first man tells the second "I hope we can outrun the bear". The second man replies "I don't need to outrun the bear. I just have to outrun you." Just as the men in the joke, companies that are slow in pulling their equipment out of Venezuela will meet with some rather unpleasant consequences.

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